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Market reactions to management earnings forecasts

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CHAPTER 5
Conclusion

5.1. Summary

The first study examines whether the *possible* earnings management of overoptimistic CEOs is recognized and included in the share price at the time the management forecast is issued, or whether investors react to the inferred (*actual*) earnings management at the announcement of realized earnings. In line with expectations the findings of the first study show that the market reacts more positively to the earnings announcements of overoptimistic CEOs in the small forecast error range compared to those of non-optimistic managers at the earnings announcement. These findings indicate that investors react negatively to the higher earnings management incentives of overoptimistic managers when the management forecast is issued and do not react to inferred earnings management of overoptimistic CEOs and/or react more positively to the inferred lack of earnings management by overoptimistic CEOs compared to non-optimistic managers when earnings are announced.

The second study examines the role voluntary management earnings forecasts play in the generation of information asymmetry among investors around public disclosures. First, the findings show that in isolation, voluntary management forecasts generate higher information asymmetry among investors than mandatory earnings announcements as evidenced by higher excess trading volume reactions associated with both pre-announcement and event-period private information at the management forecast date compared to the trading volume reaction of non-forecasting firms at the earnings announcement. This implies that the information asymmetry among investors is higher when the disclosure involves predictions for the future compared to disclosures that confirm past events. Second, earnings announcements of forecasting firms are associated with lower information asymmetry among investors than earnings announcements of non-forecasters since the excess trading volume reactions at the earnings announcement date associated with pre-announcement private information are lower, while those associated with event-period private information are not different across forecasters and non-forecasters. Finally, examining the aggregate trading volume effects of management forecasts from around the forecast issue and the subsequent earnings announcement, the study concludes that investors of forecasting firms face a larger overall information asymmetry than investors of non-forecasting firms as a result of the event-period information component.

While the aggregate information asymmetry associated with pre-announcement information is not different between forecasting and non-forecasting firms, the aggregate information asymmetry associated with event-period information is higher for forecasters compared to non-forecasters. This implies that on average a management forecast generates the same level of disagreement among investors as an earnings announcement, and moreover, that, on average, management forecasts do not help in the processing of the subsequent earnings announcement.

The third study examines whether different investor classes benefit equally from management forecasts, by comparing the economic consequences of small investors' trading decisions to those of large investors around management forecast announcements compared to earnings announcements. First, results show that the trading behavior of small and large investors at the management forecast is different compared to that around the earnings announcement, and the difference in their trading behavior differs at the management forecast compared to earnings announcements. Furthermore, the trading behavior differential can be explained by differential trading on different forecast errors, because small investors trade in the direction of a random walk forecast error around the management forecast but not around earnings announcements, in contrast with large investors, whose trades are not associated with forecast errors around corporate announcements. Second, the trading behavior differential leads to differential profitability between small and large investors at the two announcements: management forecasts improve the profitability difference of small investors' trades compared to earnings announcements by reversing a differential loss at the earnings announcement into a differential profit at the management forecast compared to large investors. Third, firm and forecast characteristics on average, do not help small investors to improve their profitability differential at management forecasts compared to earnings announcements.